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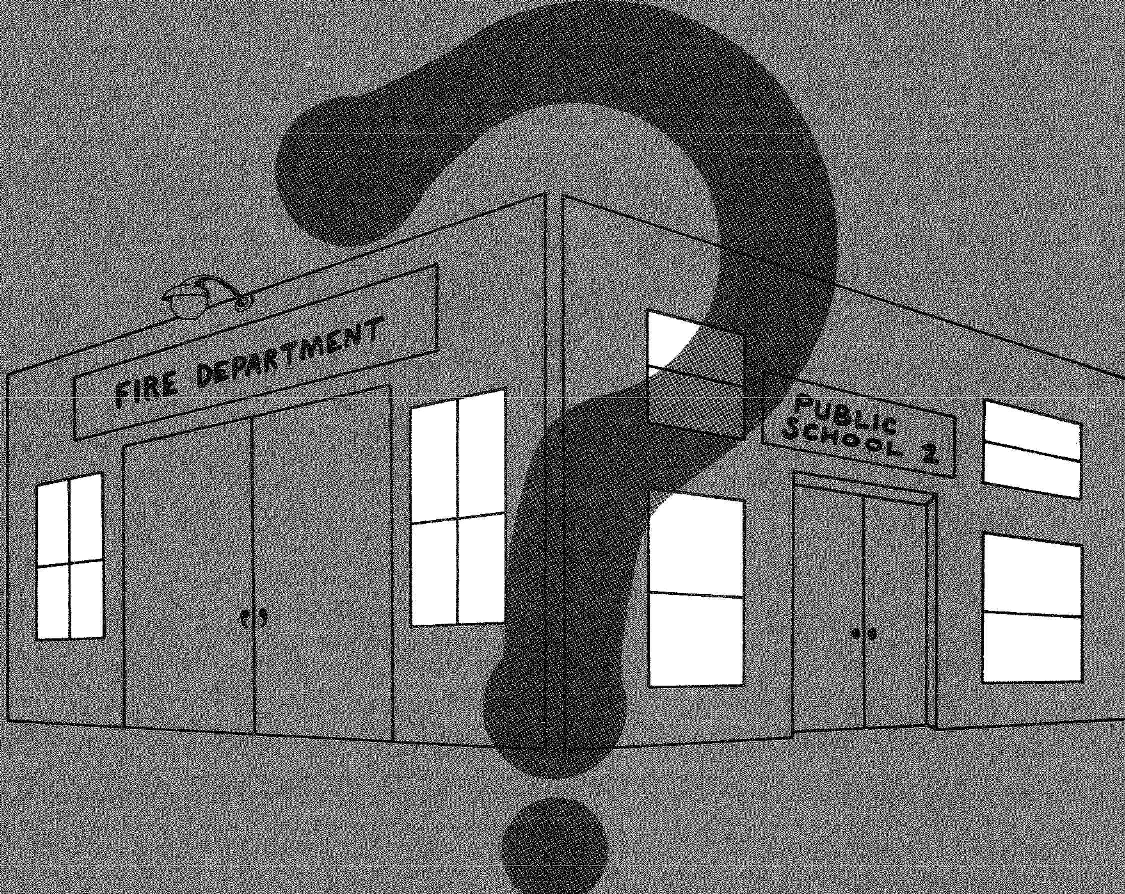

PROPOSITION 13 AND FINANCIAL MARKETS

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"Taxes," said Justice Holmes, "are the price we pay for civilized society." If that be true, Westerners were in a downright uncivilized mood in 1978, because voters in five Western states overwhelmingly adopted tax-or spending-limitation measures during the year. Voters in only one state (Oregon) rejected such a measure where it appeared on the ballot, and that may have been simply because two competing ballot measures cancelled each other out.

The most widely publicized of these measures was California's Proposition 13—the Jarvis-Gann Initiative—which was designed to reduce local property taxes 57 percent and to curb future tax increases of either the state or local variety. This $7-billion tax reduction amounted to almost one-fifth of the total revenues raised by all levels of California governments. Yet despite widespread campaign rhetoric, Proposition 13 did not bring about a collapse of California public services or public finance—nor did it usher in the millenium. Nonetheless, the measure did have important economic and financial consequences, which are evaluated in two articles in this issue of the *Review*. The third article analyzes an important financial development of the past decade—the rapid growth of the commercial-paper market.

William H. Oakland cautions that the circumstances surrounding Proposition 13 were almost unique to California. A major contributing factor to its success was a high and growing state-local tax burden during a period when similar burdens were levelling off in other states. A second factor was a substantial shift in the distribution of property-tax burdens towards home-owners, at a time when inflation already was causing budgetary problems for many households. And a third factor was the emergence of a massive California state-government surplus in the period preceding the election.

Oakland notes that Proposition 13 achieved two of its three major objectives—property-tax reduction and state-surplus liquidation. However, its initial impact on public-expenditure growth was rather modest, largely because the state government provided more than $4 billion in direct assistance to local governments out of its surplus funds. "In its first year, it required only a 2.8 percent reduction in the average level of public services; in the near future, barring a major recession, it may have little effect unless the state withholds the relief it can afford and which it seems already committed to provide."

Proposition 13 thus emerges as a tax-reform rather than an expenditure-reduction measure—one which shifts the emphasis from the property tax to the income tax. Moreover, by shifting a major portion of local revenue-raising responsibility to the state, the amendment tends to erode local control. (In view of recent court decisions, this process would have occurred in any event with respect to education.) And since the property taxes that remain are shared on a county-wide basis, the measure tends to augment the resources of fiscally weak governments at the expense of the more affluent.

Oakland emphasizes that the combination of factors which gave rise to Proposition 13 is unlikely to be matched in many other states—and the same can be said of its consequences. "The existence of a significant state surplus has mitigated its potentially disruptive impact upon the delivery of public services. This carries an important lesson for other states that have been considering measures similar to Proposition 13. Unless a considerable surplus already exists somewhere in their state-local system, they cannot expect to match the relatively smooth transition experienced by California."

Jack H. Beebe notes that Proposition 13, in addition to restricting revenue sources, also restricts increases in the state's taxing powers—and thereby blocks large increases in state taxes as an alternative source of government revenue. "Since such restrictions should affect the ability of municipalities to service and retire debt, Proposition 13's passage may adversely affect both the cost of new issues and the value of existing California municipal debt."

Beebe shows that Proposition 13 affects particular kinds of municipal debt in different ways because of the specific wording of the amendment. "For example, debt secured solely by property-tax revenues is severely affected, while other kinds of debt backed by general tax revenues are affected less or not at all." The principal debt-market casualties appear to be redevelopment agencies, the principal issuers of tax-allocation issues, which have suffered an increase in risk premium of at least 250 basis points because of the financial market's reaction to Proposition 13.

Beebe suggests, however, that restrictions on the size of government need not increase the cost of new debt or decrease the value of existing debt. "Funds needed to pay off all existing debt could be exempted from revenue ceilings (as was voter-approved debt under Proposition 13), thereby protecting all debt. Voters and government officials may wish to consider such alternatives in structuring ways to restrict government."

The articles by Oakland and Beebe indicate that notable changes have occurred to the state-local fiscal structure in an era of high inflation. A third article in this issue, by John P. Judd, analyzes an important change that has occurred in the nation's financial markets in the past decade's environment of inflation and high interest rates—the shift of a major portion of large corporate financing from large banks to the commercial-paper market. This increased reliance on direct finance through financial markets goes against the typical postwar pattern, which involves an increasing scope for financial intermediaries in channeling credit. In Judd's view, "This development stems from the unavoidable higher costs of bank as compared to paper-market credit, as well as the relatively low value of the intermediation 'services' which banks can provide to commercial-paper borrowers."

Judd asks why large corporations did not switch to the commercial-paper market at some earlier date. "First, given the consistently low interest rates of the 1950's and early 1960's, they did not feel justified incurring the costs of developing and maintaining the staff expertise to actively manage liquid assets and liabilities." Corporations established a pattern of dealing primarily with banks, even though deposit yields were somewhat lower, and loan rates somewhat higher, than those in the open-market. "Second, even after interest rates began their secular rise in the mid-1960's, corporate borrowers remained uncertain about switching to the paper market, because this meant departing from (and possibly damaging) long-standing and difficult-to-replace bank relationships."

Judd emphasizes that the greatly reduced availability of bank credit in the credit "crunches" of 1966 and 1969-70 created a new financial environment. "Once having overcome the obstacles to paper-market entry, eligible firms became very responsive to relative costs in deciding between alternative means of finance. And since bank credit is almost unavoidably more expensive than paper-market credit, the switch to the latter market is not likely to be reversed in the foreseeable future."